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IN THIS ISSUE:

BOJ Raises Discount Rate
For Fourth Time In A Year 1

Fallout From TSE Fall 3

Japanese Economy At Cruising Speed In 1989 6

Senate Panel Examines Decline
In Defense Industrial Base 9

House Hears Administration Views
On Exon-Florio 11

Foreign Companies To Face
Stronger Tax Law Enforcement 12

Notes: Japanese Budget 14

BOJ Raises Discount Rate For Fourth Time In A Year

In mid-March the Bank of Japan found itself in a familiar, although uncomfortable, position concerning a boost in the official discount rate. On one side was a rock in the form of the Finance Ministry, which felt that another increase in the key interest rate could damage the Japanese economy. On the other was a hard place formed by market-based interest rates that had risen considerably since the previous boost in the discount rate on Christmas Day last year. Raising the discount rate presumably would run counter to the wishes of the Finance Ministry, from which BOJ seldom exercises independent judgment. Keeping the discount rate at 4.25 percent would run arguably an even greater risk: increasing irrelevance to borrowers and lenders in the turmoil surrounding Japanese financial markets.

On March 20 -- after prolonged, sometimes public, coordination with the Finance Ministry -- BOJ took the plunge, raising the key interest rate a full

fixed percentage of the present market value of these latent stock assets in their equity calculations. Since lower stock prices translate into less equity Japanese banks will have more difficulty in meeting the new minimum requirements.

For foreign investors and markets the impact will be mixed. The TSE's fall may attract foreign stock investors. The usual yardsticks used by American brokers show Japanese share prices as extremely overvalued. The TSE's decline does not make Japanese stocks a bargain but does make them more reasonable. Foreign stock markets probably will benefit from the TSE's fall since it makes them relatively more attractive to Japanese investors. The relative stability of U.S. markets always has acted as a magnet to foreign investors; this perception is magnified as the TSE continues to gyrate. Conversely, a continued fall of the TSE may force Japanese investors to sell foreign assets to cover losses at home, putting downward pressure on overseas markets, although the strong cash positions of Japanese investors may limit this possibility.

Government and private Japanese criticism of computer-directed index arbitrage trading programs employed by foreign brokers recently has become muted. As the TSE tumbled in late February and early March, Japanese observers charged that such program trading accentuated the downward movement. American brokers vigorously defended their strategies by pointing out that this particular type of program trading accounted for a tiny share of the TSE's daily trading volume. In recent days market watchers have attributed a significant share of buying activity to program trading but Japanese skepticism about it persists.

For all the bad news the Japanese market retains its underlying strength. Panic selling has not gripped the market, as shown by the relatively low daily trading volumes. The dearth of buying sentiment for blue-chip stocks has propelled the major market indices downward. Buyer interest in second-section stocks and in shares sold over the counter has remained strong as the Nikkei has plunged, although the second-section did not escape the impact of Thursday's volatility. Overall, the economic picture still is quite sound. Even though some firms have announced cuts, corporate investment plans show solid growth. Employment remains firm and production high. The political situation also has improved with the Liberal Democratic Party continuing its long run as ruling party with its victory in lower house Diet elections. The March 22 passage of the supplementary budget for FY 1989 by the lower house has relieved immediate worries about fiscal deadlock.

Despite these positive factors, the TSE clearly has entered a new period. Its image of invulnerability has been shattered; Japan's susceptibility to foreign influences has been underscored; the government's cohesion has been tested; and the ties between government and industry have been strained. The cumulative impact of Tokyo's program of financial market deregulation and liberalization clearly has given market forces a much larger role and reduced Tokyo's ability to influence events.

Jon Choy

Japanese Economy At Cruising Speed In 1989

Japan's economy had to overcome numerous obstacles in 1989, including an imperial illness and death that reduced consumer demand, a new consumption tax

and almost unprecedented political uncertainty. While such events generally had a negative impact on gross national product, over the course of the year their effect was barely apparent. For calendar 1989 as a whole the economy posted a 4.9 percent inflation-adjusted gain over 1988 (see Table). While the growth rate dropped from the 5.7 percent pace set in 1988, it still was near the top among industrial countries' rates and was roughly in line with forecasts made a year ago.

By comparison the U.S. economy grew 3 percent in 1989. Since stories of Japanese economic prowess fill the U.S. news media, few Americans are likely to be surprised to hear that the Japanese economy grew faster last year. However, apparently many Americans have taken this view of Japan a step further, with nearly a majority in one widely cited 1990 poll believing that the Japanese economy is now larger than that of the United States. As with most such beliefs, such a view has a grain of truth. The latest Japanese figures -- converted into dollars at the actual 1989 average exchange rate and placed beside comparable U.S. ones -- show, for example, that plant and equipment spending in Japan in 1989 was 7.3 percent larger than in the United States. However, using the same exchange rate, the U.S. economy remains 85 percent larger than that of Japan. Most experts believe that the use of actual exchange rates -- rather than rates adjusted for relative purchasing power -- exaggerates the relative size of the Japanese economy. Use of the latter rate, if available, probably would show Japan's GNP less than half that of this country.

Because the Japanese economy is so much smaller than America's, plant and equipment spending looms correspondingly larger relative to the rest of GNP than in the United States, where under 10 percent of nominal GNP consists of such spending. In Japan investment spending by private firms accounts for almost 20 percent of GNP, and in 1989 it explained 3.7 percentage points of the overall 4.9 percent growth. In other words, other factors equal, the Japanese economy would have grown an anemic 1.2 percent in 1989 if firms had not increased their plant and equipment spending over 1988's level.

The other pillar of growth in 1989 was private consumer spending, which added 1.9 percentage points to the overall growth rate, a substantial drop from a contribution of 2.9 points a year earlier. The final important factor was external demand which, for the fourth straight year, reduced the economic growth rate; in 1989 it shaved 1 point off GNP growth. In fact, Japan's 1989 current account surplus was largely a result of falling yen-denominated import prices. (The higher yen in recent years implied lower yen prices since international dollar-denominated prices were rising only slowly.) As the table shows, in 1989 Japan registered a payments deficit on a GNP basis using 1980 prices.

In contrast to previous quarters, which had been subject to considerable volatility, the last three months of 1989 mirrored the year as a whole. October-December growth came to 3 percent on an annualized basis, compared to double-digit growth the previous quarter and negative numbers the quarter before that. Private consumer spending remained strong, contributing 0.9 percentage point to the overall 0.7 quarter-to-quarter growth rate and just matching the amount added to overall growth by private plant and equipment spending, which grew an annualized 16.2 percent.

The continuing critical importance of corporate capital spending raises a question of whether Japan's economic expansion is sustainable in light of recent policy changes. The Bank of Japan raised the official discount rate in

Japan's Real Gross National Product at Constant (1980) Prices

(in billions of yen, seasonally adjusted, quarterly totals and rates of growth at annual rates)

	1988	1989	January-March 1989	April-June 1989	July-September 1989	October-December 1989
Gross National Product	Y330,886.9 (5.7%)	Y347,059.9 (4.9%)	Y343,155.4 (7.2%)	Y340,561.8 (-3.0%)	Y350,436.0 (12.1%)	Y353,005.3 (3.0%)
Personal Consumption Spending	183,376.1 (5.1%)	189,809.4 (3.5%)	188,458.9 (5.5%)	186,600.8 (-3.9%)	190,316.3 (8.2%)	193,336.8 (6.5%)
Private Residential Construction	20,725.8 (11.9%)	21,316.9 (2.9%)	21,341.2 (1.9%)	20,855.0 (-8.8%)	21,328.5 (9.4%)	21,764.2 (8.4%)
Private Fixed Nonresidential Investment	69,343.5 (15.5%)	81,675.1 (17.8%)	77,820.6 (28.3%)	78,320.0 (2.6%)	83,374.1 (28.4%)	86,568.0 (16.2%)
Change in Business Inventories	2,314.3 (77.0%)	1,965.3 (-15.1%)	1,080.4 (*)	2,463.2 (*)	2,077.4 (*)	2,239.8 (*)
Government Current Expenditures	29,151.7 (2.2%)	29,759.4 (2.1%)	29,647.9 (2.6%)	29,650.4 (0.0%)	29,732.0 (1.1%)	30,013.1 (3.8%)
Government Fixed Investment	24,840.9 (5.6%)	24,493.8 (-1.4%)	24,674.3 (2.2%)	24,540.4 (-2.2%)	24,205.1 (-5.4%)	24,497.6 (4.9%)
Change in Government Inventories	-181.6 (*)	-62.5 (*)	261.2 (*)	371.8 (*)	63.4 (*)	-949.1 (*)
Net External Sector	1,316.2 (-79.9%)	-1,897.5 (-244.2%)	-129.0 (*)	-2,239.8 (*)	-660.8 (*)	-4,465.1 (*)
Exports of Goods and Services and Factor Income Received	59,118.6 (8.6%)	68,250.4 (15.4%)	66,337.7 (30.3%)	65,824.7 (-3.1%)	70,171.1 (29.1%)	70,863.4 (4.0%)
Imports of Goods and Services and Factor Income Paid	57,802.4 (20.7%)	70,147.9 (21.4%)	66,466.7 (44.1%)	68,064.5 (10.0%)	70,831.9 (17.3%)	75,328.5 (27.9%)

*Cannot be calculated or meaningless.

Source: Economic Planning Agency

late December and again this month (see article in this issue), suggesting the possibility that plant and equipment spending, usually highly interest sensitive despite the availability of internal funds for investment purposes, may not prove as buoyant in the future as it has in the recent past. Most industry and government officials remain optimistic concerning firms' spending plans, even though a handful of companies announced a slowdown in their investment spending in the wake of the late winter turmoil in the financial markets.

Yutaka Kosai, president of the Japan Economic Research Center, believes that the economy got through the quarter ending March 31 largely unaffected, but he is less confident about the future concerning investment spending. In addition, he and others worry that net exports may pick up should the yen remain weak. Plant and equipment spending may provide less of a boost -- and the external sector less of a drag -- than was the case in 1989. In short, the view through the rearview mirror represented by the most recent GNP figures is likely to look pretty much the same three months from now, but it could differ dramatically after that. Policymakers, who have a mandate to keep their eyes focused on the road ahead, find the landscape already is beginning to change.

Douglas Ostrom

Senate Panel Examines Decline In Defense Industrial Base

Although specific U.S.-Japan trade disputes continue to act as a lightning rod for congressional frustrations about lagging U.S. competitiveness, legislators also have begun to examine more closely some of the factors affecting the overall health of this nation's technologial and industrial base. Building on last year's oversight hearings, the Senate Banking Committee continued March 22 to hear testimony on legislation that would reauthorize the Defense Production Act of 1950, due to expire this summer. This law provides authority for preserving and enhancing the U.S. defense industrial base as well as mobilizing the nation's productive capacity during periods of national emergency.

The impact of the reauthorization process on bilateral economic relations could be significant. The increasing tendency on Capitol Hill and in certain administration quarters to link trade problems with defense needs means that a revised DPA could have as restrictive an impact on U.S.-Japan trade as specific trade sanctions. Some members of Congress have grown increasingly concerned that American high-technology and other defense-related industries are no longer able to cover the nation's security requirements autonomously. They have reacted by proposing anti-Japan, "Buy American"-type solutions (see JEI Report No. 24A, June 24, 1988).

But key representatives of American defense-related industries made no specific mention of shutting Japanese companies out of the U.S. military procurement process during recent comments to the Senate banking panel on S 1379, a bill to reauthorize and amend the DPA. Officials from aerospace and machine tool companies for the most part emphasized the need for greater government-industry cooperation in developing new technologies. The witnesses also called for antitrust exemptions to allow intraindustry cooperation in breaking new technological ground as well as various tax and other incentives that would encourage firms to invest more in advanced technology.